BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS
KRISTIN K. MAYES, Chairman
GARY PIERCE
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP

IN THE MATTER OF THE APPLICATION OF LAS QUINTAS SERENAS WATER COMPANY FOR DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY, AND AN INCREASE IN ITS WATER RATES AND CHARGES FOR WATER UTILITY SERVICE.

DOCKET NO. W-01583A-09-0589

STAFF'S CLOSING BRIEF

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") hereby files its closing brief in the above-captioned matter. In this brief, Staff will address the major disputed issues. On any issue not specifically addressed in this brief, Staff maintains its position as presented in its testimony.

I. INTRODUCTION.

Las Quintas Serenas Water Company ("Las Quintas" or "Company") is a Class C water utility providing water and service within the municipal boundaries of the Town of Sahuarita, Arizona. During the test year, Las Quintas Water Company served approximately 867 water utility service connections. The Company's present rates and charges for utility service were approved by the in Decision No. 67455 (January 4, 2005). The Company filed the instant rate application December 31, 2009, using a 12 month ending June 30, 2009 test year.

II. SUMMARY.

In its rejoinder, the Company requested a total revenue requirement of $687,117, which constitutes a 40.72% increase over adjusted test year revenues.[1] The Company has proposed an Original Cost Rate Base ("OCRB") of $2,015,574. The Company is using OCRB as its Fair Value Rate Base ("FVRB").

[1] Ex. A-6 at 2.

For its cost of capital, the Company's proposed capital structure is 67.93 percent debt and 12.07 percent equity. The Company recommends a cost of equity of 14.4 percent and a cost of debt which results in a 9.44 percent weighted cost of capital.[2]

Staff has recommended a revenue requirement of $638,117 or a 30.69 percent increase over adjusted test year revenues.[3] Staff's recommended FVRB is $1,993,221. For this proceeding Staff has proposed a hypothetical capital structure of 60 percent debt and 40 percent equity, with a cost of equity of 10.4 percent and a rate of return of 8.5 percent.

There are very few disputed issues in this case; Staff appreciates the Company's willingness to work to resolve the issues in this case. However, there remain some areas in dispute: accumulated deferred income taxes ("ADIT"); interest on key deposits; the calculation methodology for the amortization of contributions in aid of construction (CIAC), the normalization of rate case expense and rate design.

III. RATE BASE.

A. Plant in service.

The Company and Staff are in agreement on the amount of plant in service: $3,594,472.

B. Accumulated Depreciation.

The Company adopted Staff's adjustments regarding the removal of the entire cost of not used and useful plant from the accumulated depreciation balance.[4] The Company and Staff are in agreement on the accumulated depreciation balance of $1,021,769.

C. Contributions in Aid of Construction ("CIAC") and Advances-in-aid of Construction. (AIAC).

Staff and the Company propose an AIAC balance of $351,405. For the CIAC balance, both parties propose a CIAC balance of $333,555 and an accumulated amortization balance of $83,901.

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[2] Ex. A-7 at 2.
[3] Ex. S-5 at 2.
[4] Ex. A-6 at 4.

D. ADIT.

Staff and the Company continue to disagree on the ADIT. The Company has recommended an ADIT balance (an asset) of $71,046.[5] Staff has recommended an ADIT balance (a liability) of $31,307.[6]

ADIT are the accumulated temporary tax differences between income taxes calculated for rate making purposes and the actual income taxes that a company pays to the United States Treasury and the State of Arizona.[7] The timing difference is primarily due to the fact that straight line depreciation is used for ratemaking purposes, whereas accelerated depreciation is used for income tax reporting purposes.[8]

Staff and the Company agree on the basic methodology of computing the ADIT. The area of contention between the Company and Staff remains whether to include net operating loss carry forward in the ADIT calculation. Staff and the Company agree that net plant, net CIAC and net AIAC should be components included to calculate the ADIT, but the Company is also seeking to include net operating loss ("NOL") carry forwards.

The Company asserts that the NOL carry forward represents the unused portion of the special depreciation allowance that the Company elected to take during the test year. The Economic Stimulus Act of 2008 included a provision allowing businesses to claim a bonus first-year depreciation deduction of 50 percent of personal property that was acquired and placed in service during calendar year 2008.[9] This economic stimulus incentive was originally introduced in 2002 in the aftermath of the September 11 terrorist attacks. A year later, the American Recovery and Reinvestment Act ("ARRA") extended the bonus depreciation deduction through the end of 2009.[10] According to Company witness Thomas Bourassa, the Company elected to take bonus depreciation on assets purchased and placed into service during its tax year (October 1, 2008-September 30, 2009).

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[5] Ex. A-7 at 5.
[6] Ex. S-5 at 10.
[7] Ex. S-4 at 9.
[8] Ex. S-5 at 7.
[9] 26 U.S.C. § 179.
[10] Ex. A-6 at 8.

Staff witness Brown testified that ADIT provides capital comprised of the computed tax differences between income taxes calculated for rate-making purposes and the actual income taxes that a company pays to the United States Treasury and the State of Arizona.[11] Ms. Brown further testified that the components used to calculate the ADIT should reflect a net investment of capital, because ADIT are included in rate base.[12] If an amount that does not represent an investment in capital were allowed in rate base (without prior Commission approval) then investors would be allowed to earn a rate of return on an amount that is not an investment.[13] Staff asserts that including NOLs in calculating ADIT would be unfair to ratepayers.[14]

However, unused NOLs can be carried forward to offset taxable income. In past proceedings, the Commission-authorized rates included an income tax component and the Company recovered those amounts from ratepayers.[15] The inclusion of NOL in the ADIT calculation means that ratepayers would essentially be paying a carrying charge on the Company's expected future recovery of a tax benefit.[16]

E. Key Deposits.

Staff recommends that Las Quintas be required to pay interest on all customer deposits at the rate of six percent annually as a credit to customer bills.[17] Mr. Bourassa testified that the Company has accepted the Staff recommendation.[18]

IV. INCOME STATEMENT.

A. Amortization of CIAC.

In calculating its recommended depreciation expense of $113,434, Staff has used a methodology in calculating the amortization of CIAC and it is that methodology that is in dispute. The disagreement over accumulated amortization of CIAC concerns the methodology used to compute the composite rate. According to the Company, one of the underlying premises of a

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[11] Ex. S-5 at 8.
[12] *Id.* at 9.
[13] *Id.*
[14] *Id.*
[15] *Id.*
[16] *Id.* at 10.
[17] *Id.* at 7.
[18] TR. at 16:15-18.

composite rate is that all plant is funded with contributions.[19] The Company then computes a composite rate including land and then applies that rate to the gross CIAC balance.[20] Staff in the calculation has removed land from the calculation of the composite rate.[21] However, the Company also asserts because Staff has not removed land from the CIAC balance upon which it applies the composite rate, the calculation is not revenue neutral as Staff maintains.[22]

According to Staff witness Brown, the inclusion of land in the calculation of CIAC amortization expense will all the Company to earn a rate of return on land that was purchased with CIAC.[23] Allowing a return on plant purchased with CIAC is unfair to customers and unfairly enriches the Company.[24] Staff relies on guidance from NARUC for the determination of what should be included in the composite rate. According to NARUC: "Specifically, balances in account 271 which represent contributions of depreciable plant shall be amortized by charges to this account over a period equal to the estimated service life of the related contributed asset."[25] As Ms. Brown testified, this section gives support to Staff's composite rate methodology, which excludes land from the calculation.[26]

B. <u>Rate Case Expense</u>.

Staff has recommended rate case expense of $80,000 that is normalized using four years (i.e., $80,000/4 years).[27] Staff and the Company are in agreement on the amount of rate case expense. The Company disagrees with Staff's recommendation for the normalization of rate case expense. According to Staff witness Brown, Staff's recommendation to normalize rate case expense using four years is based on an analysis of the actual rate case filing experience for the Company.[28]

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[19] Tr. at 27:10-12.
[20] Tr. at 27:10-15.
[21] Ex. S-5 at 13.
[22] Tr. at 28:1-9.
[23] Ex. S-5 at 13.
[24] *Id.*
[25] Ex. S-6.
[26] Tr. at 93:6-8.
[27] Ex. S-5 at 12.
[28] *Id.* at 11.

V. RATE DESIGN.

Staff's rate design recognizes the growing importance of managing water as a finite resource and promotes more efficient water use. Staff's rate structure also provides an economic benefit to customers who limit consumption. The Company argues that Staff's rate design shifts revenue recovery away from smaller metered customers to the larger metered customers. Staff notes that the larger metered customer used more water and it is reasonable to recover a more proportional amount of revenue from them.[29]

VI. COST OF CAPITAL.

Staff has recommended a cost of equity of 10.4 percent, a cost of debt of 7.1 percent using a hypothetical capital structure of 40.0 percent equity and 60 percent debt, resulting in a rate of return of 8.5 percent.[30]

Staff employed two models to calculate the cost of equity: the discounted cash flow model ("DCF") and the capital asset pricing model ("CAPM"). The DCF model is based on the theory that the value of an investment is equal to the sum of the future cash flows generated from the aforementioned investment discounted to the present time. This method uses expected dividends, market price and dividend growth rate to calculate the cost of capital. The DCF method has became widely used to estimate the cost of equity for public utilities due to its theoretical merit and its simplicity. Staff used the financial information for the relevant six sample companies in the DCF model and averted the results to determine an estimated cost of equity for the sample companies.[31] Staff used two versions of the DCF model: the constant growth DCF model and the multi-stage or non-constant growth DCF.[32] Staff's overall DCF ranges were 9.2 percent to 10.1 percent for a DCF average of 9.7.[33]

The CAPM is used to determine the prices of securities in a competitive market. The CAPM describes the relationship between a security's investment risk and its market rate of return.[34] Using

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[29] Ex. S-5 at 17.
[30] Ex. S-3 at 2.
[31] Ex. S-2 at 14.
[32] *Id.*
[33] Manrique Surrebuttal Schedule JCM-3.
[34] Ex. S-2 at 26-27.

the historical market risk premium CAPM and the current risk premium CAPM Staff's cost of equity estimates are 8.2 percent and 14.3 percent respectively.[35] Staff's overall CAPM cost of equity is 11.3 percent which is the average of the historical market risk premium and the current market premium.

The Company argues because only one-sixth of Staff's growth estimate for its constant growth DCF model relies on historical dividend growth and is weighted 50 percent in Staff's overall DCF estimate; Staff's historical dividend growth has a lower weighting.[36] The Company's argument fails to address the fact that Staff's methodology uses a sustainable growth model which indirectly serves as check on dividend growth.[37] Because the Company does not use the sustainable growth model, it exposes the company's methodology to undesirable upward bias.[38]

The Company argues for the use of a financial risk adjustment in conjunction with the hypothetical capital structure proposed by Staff.[39] The Company cites two previous Commission Decisions for support of its argument, *in the matter of Southwest Gas Corporation*[40] and *In the matter of Arizona-American Water Company.*[41]

In *Southwest Gas*, Southwest Gas was highly leveraged and the Commission approved a hypothetical capital structure 40 percent common equity, 5 percent preferred equity and 55 percent debt. Staff did not recommend a hypothetical capital structure in that case. Staff had recommended a cost of common equity of 9.5 percent. Although Staff relied on the 9.2 percent DCF result, Staff also averaged the corroborative results of the additional methods it used: CAPM, Modified Earnings-Price Ratio and the Market-to-Book ratio which produced a range of 8.41 percent to 9.21 percent. Staff testified that the best estimate of the cost of equity capital for a company facing similar risks as that group of gas distribution companies ranges from 9.00 to 9.5 percent.[42] Staff also testified in that case, that Southwest Gas' capital structure contained less common equity than the proxy group and because of the additional risk faced by Southwest Gas, Staff recommend an equity return of 9.50

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[35] *Id.* at 29.
[36] Ex.S-3 at 4.
[37] *Id.*
[38] *Id.* at 5.
[39] Ex. A-5 at 5.
[40] Decision No. 68487, Docket No. G-01551A-04-0876.
[41] Decision No. 69440, Docket No. WS-01303A-06-0014.
[42] Decision No. 68487 at 28.

percent, that represented the high end of its reasonable range which was 30 basis points higher than its DCF recommendation.[43] It appears that the Commission adopted Staff's cost of equity recommendation but not Staff's capital structure recommendation.

In *Arizona-American*, Arizona-American and the Residential Utility Consumer Office ("RUCO") proposed a hypothetical capital structure; Staff did not. Staff's recommended cost of equity was 9.7 percent. Staff used the Hamada adjustment to increase its recommended cost of equity by 100 basis points with a final recommendation of 10.7 percent. The Commission adopted the hypothetical capital structure proposed by RUCO and the Company, but adopted Staff's cost of equity recommendation.

Staff has recommended a hypothetical capital structure in the instant case, recognizing that the Company has a higher financial risk than the proxy companies. To include an upward financial risk adjustment along with a hypothetical capital structure would effectively compensate the Company twice for its risky capital structure in relation to the sample companies.[44]

VII. CONCLUSION.

Staff respectfully requests that the Commission adopt its recommendations in this proceeding.

RESPECTFULLY SUBMITTED this 1st day of November, 2010.

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[43] *Id.*
[44] Ex. S-3 at 4.

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